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SUBJECT: NOBLE ENERGY FEARS DISPUTE WITH GOE

REF: QUITO 644; QUITO 579; QUITO 332; QUITO 905

¶1. (SBU) Summary. Noble Energy, the last U.S. company operating in the oil and gas sector in Ecuador, fears the GoE may soon initiate a process to terminate the contract of one of its subsidiaries, claiming breach of contract. Noble has 100% ownership of a fully-integrated gas-to-power project in Ecuador through its subsidiaries Energy Development Corporation Ecuador Ltd (EDC) and Machala Power. Noble has encountered difficulties with the GoE over issues with both subsidiaries, but its immediate concern regards its EDC gas operations. In 1996, EDC was awarded a 30-year concession for exploration and production of gas in Block 3 in the Gulf of Guayaquil. So far, EDC has invested over \$270 million in working the concession. The dispute centers on whether EDC has complied with its contractual obligations regarding development plans for the block. Separately, Noble is looking to sell Machala Power. End Summary.

Background

¶2. (SBU) In 1996, EDC signed a 30-year contract for gas exploration and production in the 864,000-acre Block 3 concession, located in the Gulf of Guayaquil. In 1998, EDC submitted a Development Plan for the Amistad Field, covering approximately 12,000 acres of the Block 3 concession, which was approved by government authorities. At that time, Amistad Field gas reserves were estimated at 200-400 Billion Cubic Feet (BCF). Given the GoE's acceptance of its plan, EDC moved forward with drilling. Based on the technical data acquired through the drilling, EDC lowered the estimate of gas reserves in the Amistad Field to 30 BCF. Despite the low reserve estimates, EDC proceeded with investments to allow for extraction and transportation of the gas, building an off-shore production platform, a 42-mile gas pipeline, and a gas storage facility on-shore. In 2002, to create a market for the Amistad gas, Noble constructed the 130 MW Machala Power plant using two GE single turbines; the plant began operation in August of the same year.

¶3. (SBU) After drilling three additional wells in 2004, EDC had five productive wells operating and the estimate for gas reserves in the Amistad Field was revised upward to 200 BCF. According to Noble, development of the Amistad Field was technically complex and challenging. At that point, based on technical information, EDC concluded that the Amistad Field had been properly developed and attention was focused on the production of gas to supply the Machala Power plant.

The Troubles Begin

¶4. (SBU) EDC's contract requires that it submit a Development Plan to the GoE following the exploration period of its contract. In October 2008, the contract period for exploration of Block 3

expired, and EDC submitted a development plan for the entire Block 3 concession. The GoE rejected EDC's plan, prompting EDC to submit another plan in April 2009. This latter plan amended its initial 1998 development plan and covered only the developed reserves of the Amistad Field -- 8 sub-blocks of Block 3. The remaining 62 sub-blocks (approximately 90% of Block 3 territory) were to be devolved to the GoE. The government also rejected this plan. According to EDC, the GoE is now considering the initiation of a process to terminate EDC's contract for its gas concession, claiming a breach of contract by the company. This legal process would provide a basis for government seizure of EDC's assets. The GoE followed a similar legal process when it seized the assets of Occidental Petroleum in 2006 and French oil company Perenco earlier this year (Ref A).

15. (SBU) Should the GoE decide to move against EDC, we understand that the process would commence with a letter from PetroEcuador to the Ministry of Non-Renewable Natural Resources (formerly Ministry of Mines and Petroleum) requesting that EDC's contract be terminated based on a breach of contract by the company. EDC would have 10 days to respond. EDC's contract has a provision calling for international arbitration at the International Center for Settlement of Investment Disputes (ICSID). The company's lawyers are reviewing the implications for EDC of Ecuador's decision in July 2009 to withdraw from ICSID (Ref B). Another complicating factor for EDC is the GoE's insistence that it

renegotiate its contract in the form of a service contract, in line with the country's new Constitution and draft Hydrocarbon Law, which does not allow for international arbitration of investment disputes.

The Company's Perspective

16. (SBU) According to EDC's Vice President and General Manager John Tomich, Noble believes EDC is fully in compliance with its contractual obligations based on the GoE's acceptance of its initial development plan for the Amistad Field in 1998. Noble sees the GoE's stance as an attempt to force the company to invest in further gas exploration and development because the government lacks the resources to do so. Part of what may be prompting the government to press EDC is their belief that the gas reserves in Block 3 are much larger than EDC had indicated. Tomich claimed that certain officials within PetroEcuador have told Ecuadorian President Rafael Correa that Block 3 holds vast gas reserves, despite no scientific evidence to support these claims. The only proven reserves are those explored and developed by EDC in the Amistad Field, which have been confirmed through independent auditing.

17. (SBU) The GoE is looking to significantly expand domestic gas production to reduce the country's reliance on imported gas and reduce government outlays for gas subsidies. Currently, EDC is the only gas production company operating in Ecuador. The only other source of natural gas in Ecuador is as a by-product of petroleum extraction, which is mostly lost to flaring. However, the Venezuelan petroleum company PDVSA is reportedly drilling an exploratory natural gas well on the island of Puna in the Gulf of Guayaquil.

18. (SBU) EDC is aware of two companies that have purchased Chinese made gas liquefaction plants with the intention of locating them near the EDC gas terminal in Machala, but has not been approached by the GoE regarding gas supplies for these plants. According to EDC, reserves in the Amistad Field are only sufficient to supply Machala Power. Tomich explained to Emboffs that given the current political and economic climate in Ecuador, Noble does not intend to increase its local investments, noting that it would cost around \$150 million just to drill 3-4 additional exploratory wells, from which it could take years to see results.

Machala: Hoping PPAs Will Keep Payments Coming

19. (SBU) Despite continuing payment problems, Tomich gave a more upbeat assessment of Machala Power's situation. After Machala Power's receipt of \$60 million in back payments in early 2009 as part of an agreement to withdraw its international arbitration case, unpaid invoices from the GoE have again accumulated to around

\$20 million (Ref C). However, Tomich explained that part of the difficulty in collecting on invoices in the past has been that Machala was last in line for payment because its power was sold exclusively on the spot market. On September 30, Machala Power entered into Power Purchasing Agreements (PPAs) with 20 distributors. Although Machala Power will be selling its power at a reduced price through the PPAs, it is expecting the distributors to pay close to 100% invoicing. Tomich also noted that the relatively new Minister of Electricity and Renewable Energy, Esteban Alborno, appeared to be reasonable and pragmatic.

¶10. (SBU) With the payment issue still not totally resolved, Machala Power has not moved to implement Phase II and Phase III of its contract for installation of a combined-cycle turbine and additional single-cycle turbine. Each new phase would boost energy output by roughly 90 MW, increasing Machala Power's total generation capacity to around 310 MW. Noting that Phases II and III would cost a couple hundred million dollars to implement, Tomich said Noble was not inclined to take on this additional investment, adding that Noble would prefer to sell Machala Power. Another EDC employee later told Emboff that Noble would like to sell Machala Power before the delay in implementing Phases II and III creates a problem with the government.

¶11. (SBU) Comment. Given the GoE's recent history of disputes with foreign investors and its recent decision to terminate/renege on all of its bilateral investment treaties so as to, among other things, eliminate national treatment (Ref D), EDC's concerns seem justified. In an October 23 meeting with Emboffs, Julio Gonzalez, Under Secretary for Hydrocarbon Policy at

the Ministry of Non-Renewable Natural Resources, described the status of negotiations with EDC as "bad." Should the GoE move to seize EDC's assets in the near-future, Ecuador would be embroiled in yet another international arbitration case, further eroding its image among foreign investors, and bringing to an end major U.S. investment in Ecuador's gas and oil sector. End Comment
HODGES